Testimony Before The Pennsylvania Insurance Department
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September 4, 2002

Good morning, Commissioner, and thank you for the opportunity to address the questions posed by the Department in advance of this hearing.

Let me begin by explaining the distinction between the two terms that have been used interchangeably – by us and almost everyone – during this discussion: reserves and surplus.

First, reserves: IBC's reserve fund consists of money we have accrued to pay claims that we expect to pay in the future for care that has been provided today to our members.

It is the fund set aside to deal with expected obligations.

Surplus, strictly defined, is the excess of assets over liabilities.

It is the money set aside to pay our customers' claims in the event of an unforeseen emergency.

It is the fund set aside to deal with unexpected obligations.

The Insurance Department monitors both reserves and surplus. It monitors reserves to see how accurately we have projected our responsibility for future claims. The Department wants to know that we have not paid out more claims than were projected – a situation that would require us to dip into our surplus and weaken our financial position.

And because our premiums are based, in large part, on those claims projections, the Department considers our past success in projecting claims responsibility when it considers our rate requests.

The Department also monitors our surplus level. Since 2000, the Department has required us to submit an annual Risk-Based Capital – or RBC – calculation, which measures the risk associated with IBC's book of business.

The RBC was created by the National Association of Insurance Commissioners and adopted by the Pennsylvania General Assembly as one tool to measure an insurer's financial condition.

Our surplus also is monitored by the Blue Cross Blue Shield Association, and its RBC requirements for Blue Cross Plans are significantly higher than the Insurance Department's.

In fact, as Mr. DiBona noted, by the time our RBC percentage ever dipped to Pennsylvania's so-called minimum level – the level at which the Department identifies us as weak – the Association would have removed our license to operate as a Blue Cross Plan.

Moreover, Commissioner, unless IBC operates with a surplus that is significantly above the 200% RBC level, we would further expose the company to the following threats to our financial health:

- Claims costs or utilization that exceed projected trends.
- An economic downturn and the resulting loss of membership.
- Reduced returns on investments.
- Increased benefit mandates or new limits on our ability to manage medical costs.
- New government mandates, such as HIPPA. IBC will pay about $40 million to implement this federal program designed to protect our customers' privacy and further streamline the submission and processing of providers' claims.
- Further consolidation of providers
- The entry into the marketplace of a new competitor with greater access to capital.
- And lastly, catastrophic events like the ones to which Mr. DiBona referred.

In fact, Commissioner, there was an occasion – in 1985 and 1986 – when IBC, with the approval of the Insurance Department, reduced its surplus by about one-third by sending subscribers a one-time rebate check. But what happened in the years afterward?

In order to rebuild our surplus, with the approval of the Insurance Department, IBC raised its premiums. Because our competitors were able to offer lower rates – in large part because they had access to capital – we lost 300,000 subscribers.

There have been other events that have led to a reduction in surplus. We used surplus to cover a variety of strategic investments that were deemed "non-admitted," such as systems and software development, computer hardware or aged customer premiums (receivables).

Economic conditions also had a downward impact on our surplus as our investment returns were significantly lower over the past 18 months. As the Department knows, IBC includes an investment credit in all of our customer's rates. Over the past 18 months, that credit has **exceeded** our actual return on investments – thereby affecting our surplus.

Commissioner, you asked about the relationship between our surplus and our RBC, and about major categories of risk that are considered when determining our RBC. Those risks are related to:

- Our investments
- The administrative costs of doing business
- Our underwriting, and
- The possibility that our customers will not pay their bills.

We believe that the RBC percentage which IBC has reported ever since the Department began requiring it indicates that we are making every effort to balance those risks with our surplus.

As of June 30, 2002, our RBC percentage was 382% -- satisfying the Department's action levels and those of the Blue Cross Blue Shield Association, which requires us to operate at a 375% RBC percentage.

As you know, premiums and premium growth are major factors in the NAIC's Risk-Based Capital formula. In addition, our surplus needs to keep pace with the growth in claims we are obligated to pay. The more claims we commit to pay, the greater the risk we accept. And that's what surplus is for – to cover our risk. It is the promise we make to all of our members.

You asked about the recent growth of our surplus. In fact, in each of the past 14 years, IBC has added to its surplus.

Our surplus has needed to grow – and it will need to continue growing – to keep pace with the increased risks associated with the growth of our membership and the increased cost of the claims we are committed to paying.

An excellent way to see the appropriateness of our growth in surplus is to look at our RBC percentage.

As Mr. DiBona pointed out, over the past five years, as our membership increased 45 percent, as our claims cost increased 141 percent, and as our surplus increased 51 percent, our RBC percentage remained virtually unchanged.

This is a clear indicator that our growth in surplus has not exceeded our increased risk – in fact, it has only kept pace with our growing risk – just as it should be.

But building surplus for companies like IBC is not easy – especially in times when it is increasingly difficult to have an impact on medical costs. Here is what A.M. Best reported in its 2002 outlook for the Health Insurance Industry:

> (I quote): "Recent failures (of health insurance companies) have accentuated the importance of maintaining an adequate cushion against adverse developments, placing significant urgency on companies to grow their capital base. This urgency to achieve a strong capital base has been especially difficult for not-for-profit companies...Publicly-held health insurance companies have a distinct advantage over their not-for-profit competition in that they have the ability to raise equity capital..." (end quote)

As a not-for-profit, Commissioner, IBC's primary source of increased surplus is <u>profitability</u>.

And the sources of that profitability, essentially, are three: premiums, our investment portfolio and our management of costs – IBC administrative costs and the medical costs we pay on behalf of our customers.

The Department is well aware of the significant increases that health insurance companies have needed to make in premiums in recent years, just to keep pace with medical costs. In 1990, the Insurance Department approved IBC's plan to dedicate up to 5% of a customer's premium for surplus, depending on our current level of surplus. Those guidelines permit IBC, with its current level of surplus, to dedicate an average of 2% from each customer's premium. Despite that, we have chosen in recent years to dedicate an average of only 1% from each customer's premium for surplus.

You also are aware how difficult it has become – due to legislative and regulatory mandates and other forces -- to hold down medical costs. And I can assure our customers that everyone at IBC is focused on reducing administrative costs whenever appropriate.

That leaves our investment portfolio. I have already discussed how difficult it has been to depend upon an investment portfolio over the past two years. But IBC's portfolio has played – and will continue to play – an essential role in the management of our surplus and the growth of our company.

Over the past five years, IBC has achieved an annual return on its investments in for-profit subsidiaries, such as Keystone Health Plan East, QCC (the company through which we market Personal Choice), AmeriHealth Administrators, AmeriHealth in New Jersey and Delaware, and others outside Southeastern Pennsylvania – of more than 8% per year. Much of that success is due to IBC's decisions to diversify its geographic risk and grow the company by investing in, and operating, businesses we understand. From 1998 through the end of 2001, IBC has received dividends in excess of $130 million – a cash return from those investments of over 33%.

As Mr. DiBona said, these investments – together with our traditional securities portfolio – have contributed to building a strong and respected company in a very difficult business environment. And they have helped us build the surplus that underlies our financial stability.

Despite these successes, we know that building additional surplus will remain a difficult challenge.

Why? Because as long as medical costs continue to increase at the current incredible rate, our surplus will need to grow faster than ever to keep pace with our risk of doing business.

But more importantly, to keep pace with the risk associated with keeping our promise to our customers.

After all, as Mr. DiBona pointed out, a 1% increase in utilization trends can leave IBC with $66 million in claims it had not set aside funds to pay.

The Department asked about our plans for using all or part of our surplus. In general, as Mr. DiBona made clear, we plan to use them as they are intended to be used:

<u>For paying our customers' claims or other related costs in the event of an unexpected economic situation or other emergency.</u>

In addition, since 1938, IBC has used surplus funds to reduce premiums for its non-group products. For 2003, IBC and QCC will provide direct and indirect subsidies of over $18 million to those products.

That is one example of our social mission. Let me say a bit more.

As you are aware, Commissioner, Independence Blue Cross and the other Pennsylvania Blue Cross Plans are among the few Blue Cross Plans in the country that still pursue a social mission. Even most of the Blue Cross Plans that remain not-for-profit have abandoned theirs.

But the reality surrounding our social mission is sobering: as our need heightens to increase surplus in the wake of higher and higher claims costs, it becomes more and more difficult to help meet the needs of those who benefit from IBC's social mission.

Yet we continue to help meet them.

We continue to lend significant financial support for the state's CHIP and adultBasic programs; currently we administer the CHIP program to about 24,000 children in the region, and already, we have signed up about 4,000 adults for adultBasic.

We continue to offer 22,000 Pennsylvanians a product called Special Care, low-cost health care coverage specifically designed for low- and moderate-income individuals who have no other health insurance.

We continue to stay in the Medicare + Choice business to the benefit of 145,000 Medicare beneficiaries, while other companies – publicly-traded companies, I might add – have dropped out.

We continue to serve as insurer of last resort and provide open enrollment – which no publicly-traded insurer provides;

And we do these things despite the increasingly small tax benefit of our not-for-profit status.

We do these things, Commissioner, while managing a surplus that we are proud to say reflects the financial strength of Independence Blue Cross – to the great advantage of all of our policyholders and customers.

Now I would like to introduce Jim Roberts, an actuarial partner, specializing in health insurance for Ernst & Young.

Thank you.